Before the
FEDERAL COMMUNICATIONS COMMISSION
Washington, D.C. 20554

In the Matter of	)	
	)	
Price Cap Performance Review for Local Exchange Carriers; Treatment of Video Dialtone Services Under Price Cap Regulation	)	CC Docket No. 94-1

REPLY COMMENTS

Comcast Cable Communications, Inc. and Cox Enterprises, Inc., by their attorneys, hereby submit their reply comments in the Commission's Third Further Notice of Proposed Rulemaking in the above-referenced docket.[1/]

I. INTRODUCTION

In their initial comments, Comcast and Cox demonstrated that the Commission's establishment of a separate video dialtone price cap basket in the *Second Report and Order* will be ineffectual without additional changes to the Commission's accounting rules.[2/] Specifically, the Commission must prescribe the proper allocation of common costs between video and telephone services. If this critical decision is left to the discretion of a LEC offering video dialtone, the purpose of the separate price cap basket will be subverted because the LECs have the incentive and ability to misallocate video costs to telephone services.

The comments filed in response to the *Third Further Notice* confirm that common cost allocation must be addressed by the Commission if the separate price cap basket is to have its

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1/ *Price Cap Performance Review for Local Exchange Carriers; Treatment of Video Dialtone Services Under Price Cap Regulation*, Second Report and Order and Third Further Notice of Proposed Rulemaking, CC Docket No. 94-1, FCC 95-394 (rel. September 21, 1995) ("*Second Report and Order*" or "*Third Further Notice*").

2/ Comments of Comcast Cable Communications, Inc. and Cox Enterprises, Inc. ("Comcast and Cox") at 3.

desired effect of minimizing cross-subsidization.[3] A number of these comments are consistent with Cox's proposal that the Commission allocate LEC network rebuild costs prior to Part 36 jurisdictional separations, with no more than 50 percent of costs allocated to telephone services.

The Commission cannot, as suggested by certain LECs, simply rely on the existing Part 36 rules to ensure the proper allocation of costs.[4] These rules were adopted for pure telephone networks, not the type of integrated video/telephone facilities at issue here, and therefore allocate costs primarily to the intrastate jurisdiction. Video dialtone, however is principally an interstate service, which requires a completely different jurisdictional allocation. Notwithstanding this significant difference, the Commission has given the LECs discretion to apply Part 36 rules to video dialtone investments as they choose. Given the tremendous potential for misallocation that exists under this situation, at a minimum the Commission must prescribe how Part 36 rules are to be applied by the LECs if the potential for cross-subsidization is to be reduced.

The Commission also must reject BellSouth's request for exceptions to the separate price cap basket requirement for trials and for LECs electing a no-sharing option.[5] BellSouth's argument ignores the fact that many of the "trials" conducted by LECs involve investments that are substantially larger than some commercial offerings and therefore have an equal risk of cross-subsidization. Similarly, the election of a no-sharing option under the LEC price cap rules does not eliminate a LEC's incentive to misallocate video costs to telephone services because the productivity factor is based on costs. Therefore, there is no basis for diluting the requirements applicable to LECs as suggested by BellSouth.

3/ Comments of the National Cable Television Association, Inc. ("NCTA") at 4; Comments of the General Services Administration ("GSA") at 8.

4/ Comments of Bell Atlantic at 2-3; Comments of Southwestern Bell Telephone Company ("SWBT") at 11.

5/ Comments of BellSouth at 2-3.

II. THE COMMENTS SUPPORT ADOPTION OF A 50/50 ALLOCATION OF COSTS BETWEEN VIDEO AND TELEPHONE SERVICES.

Comcast and Cox demonstrated in their initial comments that a separate price cap basket would not be effective without additional changes in the Commission's accounting rules because LECs still have complete discretion as to the allocation of common costs.[6] As stated by NCTA:

> The allocation issue is the most important policy decision the FCC will make in this regulatory proceeding. A separate price cap basket is simply a way of enforcing that decision.[7]

The Commission's failure to prescribe cost allocation procedures shifts the burden of scrutinizing LEC video dialtone investments to state regulators and increases the potential for misallocation of costs. Because the Commission's jurisdictional separations rules currently permit LECs to allocate 75 percent of loop costs to the intrastate jurisdiction, 47 C.F.R. § 36.154(c), failure to separate video and telephone costs before the jurisdictional separations process means that the bulk of network rebuild costs may be categorized as intrastate telephone costs. States will then face the difficult task of determining which of these costs should be disallowed in determining telephone rates -- even though video dialtone is principally an interstate service.

An easily administered solution to this problem that has been proposed by Cox is to allocate 50 percent or more of LEC network rebuild costs to video and up to 50 percent to telephone services.[8] Existing Part 36 and Part 64 rules then would be applied to each portion

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6/ Comments of Comcast and Cox at 3.

7/ Comments of NCTA at 4.

8/ Letter from Laura H. Phillips, Esq. to William F. Caton, CC Docket Nos. 87-266 and 94-1 (July 12, 1995) (Attached as Exhibit A). As explained in Cox's Petition for Reconsideration, the Commission rejected this proposal without analysis in the *Second Report and Order*.

of the investment in order to separate nonregulated and intrastate costs. Under this proposal, telephone and video costs would be clearly distinguished and state regulators would not be forced to determine which intrastate costs should be disallowed for telephone ratemaking purposes.

The Cox proposal minimizes the present disparity between the accounting treatment of LEC Title II video dialtone services and LEC Title VI cable systems. Under the current rules, a LEC can assign a greater portion of network rebuild costs to telephone services if it offers Title II video dialtone rather than Title VI cable service because cable service is treated as a nonregulated service and thus is subject to fully distributed cost treatment under the Part 64 cost allocation rules. By contrast, under the new services test, a LEC can assign to Title II video dialtone the "incremental" cost of the facility. Given the Commission's goal of ensuring that telephone ratepayers do not foot the bill for LEC network rebuilds necessary for video services, the accounting treatment of LEC network rebuilds should be the same, regardless of the regulatory model under which service is provided.[9/] The Cox proposal would achieve this goal in a manner that minimizes the administrative burden that exists under the current system, in which the Commission must monitor on a case-by-case basis the varied allocation procedures employed by the LECs.

Allocating LEC network rebuild costs on a 50/50 basis is a fair compromise between the Commission's desire to spur investment and its duty to prevent cross-subsidization. The broadband facilities proposed by LECs for video dialtone are not necessary for the provision of

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9/ This analysis applies only to integrated video/telephone facilities. If a LEC constructs a stand-alone cable system, none of the costs should be borne by telephone ratepayers. Indeed, telephone ratepayers should be compensated for any use of the telephone network by the stand-alone cable system (*e.g.*, use of pole attachments and conduit). *See Telephone Company-Cable Television Cross-Ownership Rules,* CC Docket No. 87-266, Petition for Clarification or Reconsideration of Cox Enterprises, Inc. and Comcast Cable Communications, Inc. (filed September 25, 1995) (seeking confirmation that all costs of a stand-alone cable system will be treated as non-regulated under Part 64 rules and that cable operators will be afforded access to poles and conduit on the same terms as LECs provide themselves).

telephone service and the Commission would be wholly justified if it determined that all broadband costs should be presumptively assigned to video.[10/] LECs, on the other hand, argue that video dialtone will not be economically feasible unless the lion's share of the costs are assigned to telephone services. The 50/50 proposal is a simple, reasonable compromise between these two competing positions.

Numerous parties filed comments supporting solutions similar to those proposed by Cox. MCI, for example, agrees that a 50/50 allocation between video and telephone services is a reasonable approach:

> In the context of loop investment, which is likely to be the largest joint and common cost, a 50 percent allocator can be justified under the theory that the loop facility is now supporting two loops -- a telephone loop and a broadband loop. Each splits the cost.[11/]

GSA agrees that the separation of video and telephone costs should take place prior to the Part 36 jurisdictional separations process. GSA favors separating video and telephone costs at the Part 64 level, but its comments demonstrate that the Part 36 rules, if interpreted correctly, potentially can achieve the same objective.[12/] As described below, GSA's Part 36 proposal assumes that Category 1 cable and wire costs will be allocated to telephone services and Category 2 will be allocated to video, with costs allocated between the two categories based on bandwidth. The Commission, however, has not prescribed this allocation nor has it even determined how LECs have been applying the Part 36 rules. Therefore, reliance on the Part 36 rules at the present time is inadequate to prevent cross-subsidization.

10/ The Canadian Radio-television and Telecommunications Commission recently adopted this type of proposal. *Implementation of Regulatory Framework - Splitting of the Rate Base and Related Issues*, Telecom Decision CRTC 95-21 (October 31, 1995).

11/ Comments of MCI Telecommunications ("MCI") at 7-8.

12/ Comments of GSA at 8.

The comments of MCI and GSA demonstrate that LEC customers have substantial concerns that they, not LEC shareholders or video customers, will be forced to foot the bill for LEC video dialtone investments. The mere adoption of a separate price cap basket for video dialtone is not sufficient to resolve these concerns. Accordingly, the Commission must take additional steps in this proceeding to ensure a proper allocation of common costs.

III. THE EXISTING PART 36 RULES ARE INADEQUATE TO PREVENT MISALLOCATION OF VIDEO DIALTONE COSTS.

In the *Video Dialtone Reconsideration Order*, the Commission recognized that the existing Part 36 jurisdictional separations rules may be inadequate as LECs begin to deploy integrated broadband facilities capable of providing a range of voice, video and data services.[13/] Given the importance of the Part 36 separations process, the Commission stated that it would monitor the LEC's application of Part 36 to video dialtone and conduct a rulemaking to address separations issues.[14/]

Notwithstanding the Commission's recognition that concerns exist as to the ability of Part 36 to function properly when applied to broadband investments, Bell Atlantic and others insist that the existing Part 36 rules are adequate to ensure that video dialtone costs are properly assigned to the video dialtone basket.[15/] As Comcast and Cox demonstrated in their initial comments, this is not the case.

LECs have not yet disclosed how they are applying the Part 36 rules, but presumably most network rebuild costs are being allocated between Category 1 Cable and Wire Facilities

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13/ *Telephone Company-Cable Television Cross-Ownership Rules*, Memorandum Opinion and Order on Reconsideration and Third Further Notice of Proposed Rulemaking, 10 FCC Rcd 244, 333 (1994) ("*Video Dialtone Reconsideration Order*").

14/ *Id.*

15/ Comments of Bell Atlantic at 2-3; Comments of SWBT at 11.

(C&WF) (exchange line) and Category 2 (wideband). These categories were developed at a time when LECs operated pure telephone networks and the rules were not intended to accommodate the type of integrated broadband facilities used to provide video dialtone. As suggested by AT&T, "because video dialtone is fundamentally different than the basic telephony services, it may warrant a separate Part 36 category."[16/]

Section 36.153(a) of the Commission's rules requires allocation between categories of C&WF based on "conductor cross section." 47 C.F.R. § 36.153(a)(1). GSA correctly suggests that this rule requires an allocation between categories based on bandwidth,[17/] but the Commission has yet to prescribe such an interpretation and it seems highly unlikely that LECs have interpreted the rules in this manner. The reason for this is that an allocation based on bandwidth would assign most costs to Category 2, but LECs have a tremendous incentive to allocate costs to Category 1, because 75 percent of Category 1 costs are allocated to the intrastate jurisdiction. 47 C.F.R. § 36.154(c).

The existing uncertainty as to how Part 36 rules apply to video dialtone investments and the corresponding potential for misallocation explains why many of the LECs argue that no changes in the Part 36 rules are needed. As recognized by U S West, however, video dialtone cost allocation issues associated with joint and common investments are Part 36 issues that have not yet been resolved.[18/] U S West's assertion that these are not price cap issues to be resolved in this proceeding misses the point made by NCTA that price cap rules are simply a method of enforcing the allocation decisions that must be made by the Commission.[19/] Accordingly, if the separate price cap basket established in the *Second Report and Order* is to have any effect, the

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16/ Comments of AT&T at 8.

17/ Comments of GSA at 7.

18/ Comments of U S West at 3.

19/ Comments of NCTA at 4.

Commission cannot rely on Part 36 rules until it prescribes how these rules are to be applied to video dialtone investments.

The Commission could minimize the need to become enmeshed in a case-by-case resolution of these Part 36 issues by adopting the 50/50 allocation proposal discussed above. If costs are separated on a 50/50 basis before Part 36 jurisdictional separations, the jurisdictional separations process becomes much simpler. Telephone costs would be allocated under Part 36 as they are today. Video costs could be allocated between jurisdictions based on the ratio of interstate channels to intrastate channels, or some other measure that reflects the predominantly interstate nature of video dialtone This proposal represents a simple way for the Commission to ensure that intrastate ratepayers are not unfairly burdened with video dialtone investments without shifting responsibility for this task to regulators in each state where video dialtone, which is essentially an interstate service, is offered.

IV. THERE SHOULD BE NO EXCEPTIONS TO THE RULES ESTABLISHED IN THIS PROCEEDING.

In the *Second Report and Order*, the Commission established an exception to the separate video dialtone price cap basket requirement for situations in which the LEC's investment is *de minimis*.[20] Not content with the *de minimis* exception, BellSouth asks the Commission to exempt from the allocation rules adopted here any LEC investment in a video dialtone trial, as well as any LEC that elects a no-sharing option under the price cap plan.[21] Both of these would increase the risk that LEC video dialtone facilities would be subsidized at the expense of telephone ratepayers, and therefore they must be rejected.

20/ *Second Report and Order* at ¶ 35.

21/ Comments of BellSouth at 2-3.

The proposed exception for video dialtone trials is simply a variation of the *de minimis* exception, but one with an even greater potential for abuse. As shown in petitions for reconsideration of the *Second Report and Order*, there is no basis for the *de minimis* exception.[22/] LECs already are required to account separately for video dialtone costs and reporting these costs in a separate price cap basket should not be a burdensome task. Furthermore, creating an exception to the requirements adopted in this proceeding increases the administrative burden for the Commission because it will be necessary to determine whether the exception applies.

If a *de minimis* exception is retained, the trial exception would be unnecessary. There is nothing about a trial versus a commercial offering that reduces a carrier's incentive or ability to cross-subsidize. Any trial for which a LEC's investment rises above the *de minimis* level should be subject to the allocation rules adopted in this proceeding. When a carrier tests video dialtone on a massive scale, such as U S West's "trial" in Omaha, the facilities constructed are the same as they would be for a commercial offering and they should be subject to the same regulatory treatment.[23/]

The request to exempt LECs that elect a no-sharing option is equally meritless. As long as the price cap productivity factor is based on costs, LECs will have an incentive to misallocate costs from video to telephone services.[24/] By disproportionately allocating costs to telephony, a LEC can lower its productivity for those services, thereby reducing the productivity factor (and

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22/ Petition for Reconsideration of Cox Enterprises, Inc. at 2; Petition for Reconsideration of MCI at 1.

23/ U S West's "trial" facility, which passes 50,000 homes, cost in excess of $30 million. Under no circumstances should an investment of this magnitude not be subject to the allocation rules adopted in this proceeding.

24/ *See* Letter from James O. Robbins, President and CEO, Cox Communications, Inc., to Reed E. Hundt, Chairman, Federal Communications Commission (June 28, 1995) (Attached as Exhibit B).

the amount that prices must fall) in subsequent years. Consequently, there is no basis for exempting any LEC from cost allocation requirements merely because it has elected a no-sharing option under the price cap rules.

V. CONCLUSION

The establishment of a separate price cap basket for video dialtone is an important step in preventing cross-subsidization of LEC video dialtone facilities, but standing alone it is inadequate to the task. As shown in the comments filed in this proceeding, the Commission will not achieve its goal of protecting telephone customers from the financial burdens of video investment until it prescribes procedures for the allocation of common costs. The 50/50 allocation proposal advanced earlier in this proceeding represents a reasonable approach that is both fair and simple. Even if the Commission does not adopt this approach, it cannot rely on the existing Part 36 rules to prevent misallocation of costs. Furthermore, the Commission should not dilute the requirements adopted in this proceeding by created unnecessary exceptions for video dialtone trials and LECs that elect a no-sharing option.

Respectfully submitted,

COMCAST CABLE COMMUNICATIONS, INC.
COX ENTERPRISES, INC.

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November 20, 1995

EXHIBIT A

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July 12, 1995

RECEIVED
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FEDERAL COMMUNICATIONS COMMISSION
OFFICE OF THE SECRETARY

VIA MESSENGER
Mr. William F. Caton
Secretary
Federal Communications Commission
1919 M Street
Washington, D.C. 20554

EX PARTE

Re: CC Docket No. 87-266

Dear Mr. Caton:

On Tuesday, July 11, Alexandra Wilson and Alexander Netchvolodoff of Cox Enterprises, Inc. met with Richard Welch, Legal Advisor to Commissioner Chong, to discuss the Commission's Fourth Further Notice of Proposed Rulemaking in the above-referenced docket. A copy of the handout distributed during the meeting is attached. This letter was not filed until today due to the late time of the meeting.

Please contact the undersigned should you have any questions with regard to this filing.

Sincerely,

Laura Phillips

Laura H. Phillips

cc: Richard Welch

COX POSITION ON FOURTH FURTHER NOTICE IN VIDEO DIALTONE RULEMAKING PROCEEDING

- The Commission created the concept of video dialtone in response to the statutory prohibition that prevents telcos from providing video programming directly to subscribers over their own networks. Now that the courts have declared the statutory ban unconstitutional, telcos are free to offer video programming over their networks as Title VI cable operators (subject to appropriate safeguards), and all of the goals articulated by the Commission in establishing video dialtone have been met. Accordingly, Cox believes that there no longer is a need for video dialtone.

- If the Commission nonetheless determines that sound policy reasons for video dialtone continue to exist, it must clearly articulate (a) what those policy reasons are, (b) why those objectives cannot be met through operation of Title VI cable systems, and (c) how video dialtone is different from traditional cable service. The Commission also must make it clear that anyone (including cable operators) can elect to provide video dialtone; VDT must not be declared the exclusive province of the telcos.

- The Communications Act unequivocally states that a telco that offers programming directly to subscribers over its own network is a "cable operator" providing "cable service" over a "cable system" pursuant to Title VI. As the legislative history demonstrates, moreover, Title VI applies to both the programming service and the underlying facilities used to provide the programming service. The only portion of a telco video network that conceivably could be considered a Title II common carrier service is that portion of the network (if any) offered on a common carrier basis to unaffiliated programmers.

- Assuming the Commission offers telcos (and cable operators) who offer programming on their networks the option of providing video common carriage in addition to cable service, the Commission should ensure that its rules do not create an artificial regulatory incentive to opt for one business model over the other. The decision whether to offer a common carrier platform to unaffiliated programmers should be based on business considerations which reflect the real interests of consumers. It should not be reached because policy makers have decided to implement an industrial policy that pushes (through artificial accounting or other regulatory incentives) the owners of video networks toward video common carriage, even when the business case does not support such a result.

- The most important thing the Commission can do to ensure that its regulations are neutral with respect to selecting a business model is to make it clear that telcos who choose to offer video programming over their own networks will not be entitled to put a greater burden on telephone ratepayers if they opt to provide a common carrier platform in addition to cable service than if they elect to provide cable service alone. This means that the FCC rules used to allocate the costs of an integrated broadband facility between telephony and video services should not be more favorable if video common carriage is offered than if it is not. After all, the key goal of cost allocation is to guarantee that telephone ratepayers do not foot the bill for an upgrade that is undertaken principally to add video capabilities. Clearly, the portion of the upgrade costs that those ratepayers are required to bear should not depend on whether some of the video services carried over the network happen to be offered under Title II while others are offered under Title VI.

- The Commission could achieve the desired result of cost allocation neutrality by adopting a few very simple rules:

    1. Telcos would be allowed to allocate to the telephone ratebase a maximum of 50 percent of the costs of any future telco upgrade. (This is an extremely generous allocation of costs for the telcos, since the real reason they are upgrading their networks is to provide video and other broadband services, not to add new narrowband services.) The remaining 50 percent of the upgrade costs would be allocated to video and other broadband services (whether regulated or unregulated).
    2. The 50 percent of the upgrade costs allocated to video/broadband services in turn would be assigned among regulated and unregulated video/broadband services using Part 64 of the FCC's rules. The portion of costs assigned to regulated video/broadband services (such as video common carriage) would then be subjected to the traditional Parts 36[1] and 69 analysis in order to establish just and reasonable tariff rates for the regulated services. A schematic diagram of the proposal is attached.

- This approach would be simple to administer, would protect telephone ratepayers from shouldering an undue portion of the costs of a broadband upgrade, and would avoid many of the subjective judgment calls that are inherent in a more traditional Title II analysis. It also would treat all facilities-based video programmers equally and ensure that one video network did not have an unfair regulatory advantage over another.

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[1] Cox urges the Commission to initiate promptly its promised proceeding to modify the Part 36 jurisdictional separations rules to accommodate video common carriage services.

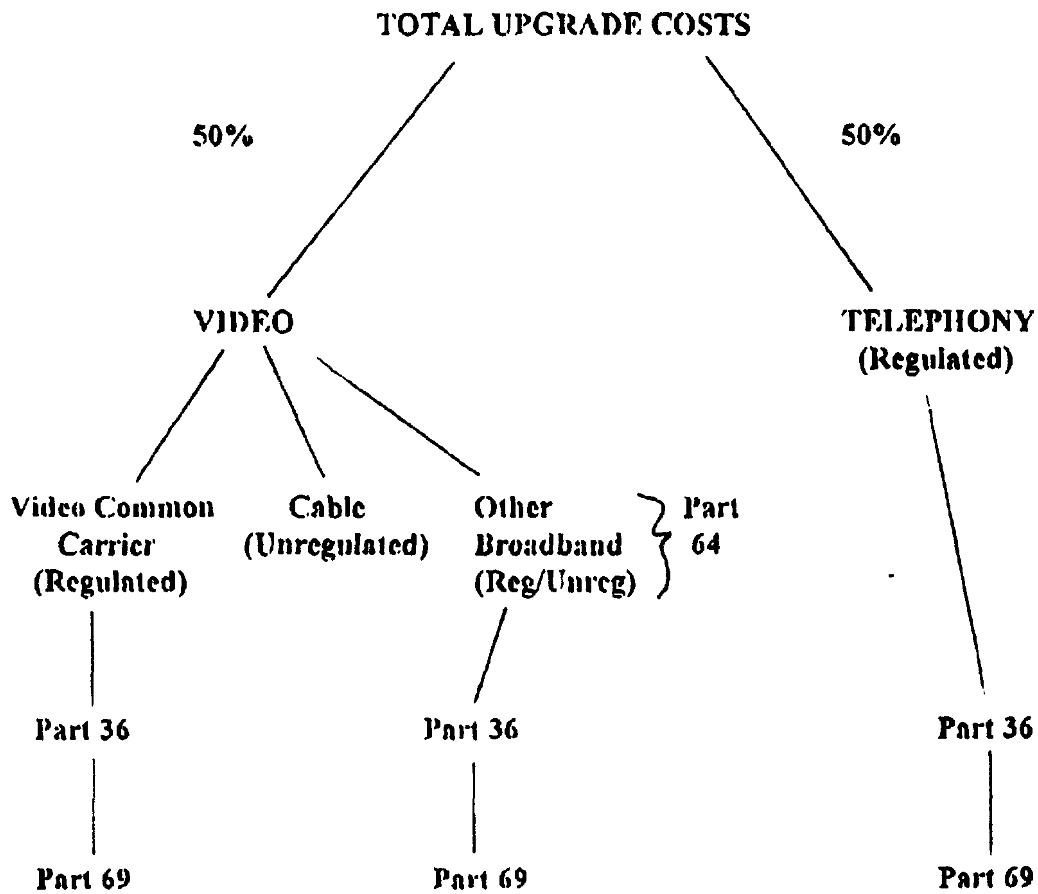
TOTAL UPGRADE COSTS
50%
50%
VIDEO
TELEPHONY (Regulated)
Video Common Carrier (Regulated)
Cable (Unregulated)
Other Broadband (Reg/Unreg)
Part 64
Part 36
Part 36
Part 36
Part 69
Part 69
Part 69

EXHIBIT B

James O. Robbins
President and Chief Executive Officer

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COX COMMUNICATIONS

June 28, 1995

The Honorable Reed E. Hundt
Chairman
Federal Communications Commission
1919 M Street, NW, Room 814
Washington, D. C. 20554

Dear Mr. Chairman:

Much is made about an assertion that price cap regulation of LECs eliminates their incentive to cross subsidize new services from their monopoly rate base. Flowing from this assertion, it is argued that there is no need for the FCC to impose reasonable cost allocations between telephony and video dialtone services because price caps eliminate cross-subsidies.

Enclosed is a white paper by Snavely King and Associates which debunks this assertion whether it is based on: (1) the FCC's existing price cap regime; or (2) a theoretically reformed FCC "pure" price cap regime in which sharing options are eliminated.

First, the FCC's existing price cap regime permits LECs to game the system by moving from high price caps with no sharing to lower price caps with sharing as their anticipated revenues and future sharing obligations dictate. If LECs misallocate costs to telephony, thereby artificially depressing telephony earnings, virtually all of the productivity benefit from the price cap is lost. In other words, under the existing Commission's price cap regime, the LECs have every incentive to transfer virtually all of the costs of VDT to their captive rate base.

Second, even if the Commission reforms its existing price cap regime to eliminate the sharing options, some adverse effects of cross-subsidy from improper cost allocation will remain because the misallocation of common costs to telephony always will deflate the productivity factor and offset the expected decline in regulated telephone costs to consumers.

Third, under existing jurisdictional separations rules, state regulators face 75% of the consequences of cost misallocation to telephony without any remedy under the VDT tariff process. Moreover, many state regulators face changes in state law which, under reform of state price caps, forbid the collection of cost and revenue data needed to address the local VDT cross-subsidy issues.

Cost accounting without cost allocation is like Yin without Yang. The responsibility to confront and decide this fundamental public policy issue quite simply cannot be avoided by claiming price caps prevent cross-subsidy since, as our analysis shows, they do not. In light of this reality, the Commission should immediately take several concrete steps to protect telephone ratepayers: (1) revise Part 64 and 36 accounting rules to separate <u>all</u> video dialtone costs from telephone costs prior to the jurisdictional separation process; (2) determine a reasonable allocation of common costs that must be applied in all VDT tariffs; and (3) impose procedures that exclude VDT from price caps and from all price cap productivity factor calculations.

Sincerely,

Jim Robbins

Enclosure

cc: The Honorable James H. Quello
The Honorable Andrew C. Barrett
The Honorable Rachelle B. Chong
The Honorable Susan Ness

Effect of Video Dialtone Cross-Subsidies on Price Cap Carriers

Report by
Snavely, King & Associates, Inc.
to Cox Enterprises, Inc.

The video dialtone systems proposed by a number of Local Exchange Carriers ("LECs") are not profitable. In LEC filings, common video/telephony costs and corporate overhead costs are underassigned to video dial tone. As these video dialtone systems are built, they will be financed and sustained by heavy cross-subsidies from telephony operations.

The argument has been made that cross-subsidies are of no consequence to ratepayers of monopoly telephone services because the "price cap" scheme adopted by the Federal Communications Commission ("FCC") insulates consumers from the effects of misallocations. Telephone ratepayers, it is argued, are protected from any effects of overstated costs, including cross-subsidies of video dialtone services, because the LEC's actual costs and productivity are not used in the formula for updating the price cap. The formula simply subtracts the productivity option chosen by the LEC from the inflation rate (see Figure 1 attached for options).

The way this consumer insulation is supposed to work is illustrated by Figure 2. A carrier electing the "pure" price cap option (i.e. no requirement to share profits above a certain amount with ratepayers) must offset inflation by an annual productivity factor of 5.3 percent, but it may keep any earnings it can achieve. Inflation is assumed to be 3.3 percent annually in this illustration. Therefore the price cap index declines 2.0 percent each year. This is the rate by which the hypothetical carrier must reduce its telephone rates.

The illustration continues by assuming that the carrier actually achieves a 5.3 percent productivity and thus earns 13.65 percent each year. However, the rate of return, whatever it is, has no bearing on the movement of the price cap index.

There are three reasons why the argument illustrated by Figure 2 is wrong, and why video dialtone cross-subsidies do affect telephone ratepayers. The three reasons relate to (1) jurisdictional separations, (2) interstate profitability, and (3) industry productivity.

1. Jurisdictional Separations

By law, the FCC must separate the costs of telephony between interstate and intrastate services. At present, there is no formal recognition of video dialtone services in the Part 36 separations rules. To date the allocation of costs for video dialtone are following the allocations contained in the LECs' proposed video dialtone tariffs. If these proposed tariffs understate the cost of video dialtone, they overstate the cost of telephone services. Existing separations procedures (Part 36) allocate approximately 75 percent of telephone service costs to the intrastate jurisdiction. Thus, each $1.00 overstatement of telephone costs by reason of video dialtone cross-subsidies inflates intrastate jurisdictional costs by 75¢.

Whether or not a carrier chooses the no sharing "pure" price cap option for interstate services has absolutely no effect on intrastate ratemaking. The only way to protect intrastate telephone ratepayers from paying for video dialtone subsidies is to ensure that intrastate telephone costs do not include video dialtone costs. To address this issue, the Commission should revise its Part 64 accounting rules to separate all video dialtone costs from telephone costs before these costs are separated by jurisdiction. This will ensure that no video dialtone costs will be supported by intrastate telephone ratepayers.

2. Interstate Profitability

According to LEC tariff filings, the provision of video dialtone service in the initial years will increase costs more than revenues. This early unprofitability will influence the LECs' choice of price cap options. As discussed above, the "pure" price cap option requires a 5.3 percent productivity offset and results in an annual rate reduction of 2.0 percent. However, if the carrier anticipates that video dialtone will lower its overall profits, it will not opt for the "pure" price cap option, but will choose one of the "sharing" options that does not carry such a high productivity offset. The carrier will opt for the price cap option which minimizes its total rate reduction requirement as a result of both the formula and sharing. The carrier will choose the lowest productivity offset available, unless this choice will cause it to lower rates more through sharing than it avoids by choosing a low productivity offset.

In Figure 3, it is assumed that the carrier initially earns 13.65 percent, which is above the 12.25 threshold for sharing under the two sharing options. However, consistent with the data from LEC tariffs, Figure 3 assumes that video dialtone costs reduce realized productivity by 3.0 percent to 2.3 percent. This drop in productivity will cause lower earnings. Anticipating this, the carrier will choose the 4.0 percent productivity factor, the lowest price cap productivity option. This choice produces a net annual price reduction of only 0.7 percent. Under this option, the carrier must share earnings between 12.25 and 13.25 percent on a 50/50 basis, and it must refund all earnings greater than 13.25 percent. In this illustration, video dialtone service has reduced the carrier's return to 12.80 percent. Therefore, sharing deprives the carrier of only .275 percent [1] of its earnings in the first year. In the second and third years, video dialtone further depresses earnings to 11.95 percent and 11.10 percent, respectively, so the carrier shares no earnings whatever.

Since carriers choose one of the three price cap options each

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[1] 12.80%-12.25% = .55% x 50% = .275%

year, the advent of video dialtone will likely result in a migration of LECs from the highest productivity, non-sharing option to the lower productivity, sharing options. As demonstrated by the first three years of Figure 3, the effect on ratepayers is an annual price cap adjustment that is 1.3 percentage points higher with video dialtone than without it.

The Commission can insulate interstate telephone ratepayers from this effect by imposing procedures to exclude video dialtone revenues and costs from the earnings that are used to compute the sharing obligation. However, if there is a cross-subsidy, and a portion for the common costs that should be assigned to video dialtone are assigned to telephone services, this exclusion fails to resolve the problem. Telephone service earnings will decline, and carriers will opt for the lower price caps in the confidence that they will not become subject to earnings sharing.

3. Industry Productivity

In its recent price cap order, the Commission found merit in basing the productivity offset in its price cap mechanism on a moving 5-year average of the industry's productivity performance. The effect of adding significant new video dialtone inputs without a corresponding (in the near term) increase in outputs will be to reduce the industry's productivity performance. The moving average of productivity performance will decline, and with it the productivity offset.

The consequence of this effect is illustrated in Figure 3 in Years 4, 5, and 6. Figure 3 assumes that in Year 4 the Commission observes that the industry's productivity performance has fallen to 2.3 percent and the productivity offset is set at this level. Combined with an inflation rate of 3.3 percent, this offset allows an annual <u>increase</u> in rates of 1.0 percent, instead of the 2.0 percent <u>decrease</u> discussed above.

Again, the Commission can insulate telephone ratepayers from this effect by imposing procedures to exclude video dialtone inputs and outputs from the annual productivity performance calculation. However, if there are cross-subsidies, and video dialtone costs are allowed to inflate telephony inputs, then the telephone productivity factor will decline in spite of the Commission's efforts to segregate these two lines of business for purposes of rate regulation.

<u>Conclusion</u>

In the attached illustration, the cumulative six-year effect of video dialtone on interstate telephone ratepayer is an increase of 12.9 percent in their rates. With no video dialtone costs, rates fall by 12.0 percent, as shown on Figure 2. With video dialtone costs, rates increase by 0.9 percent. This is in spite of the fact that the hypothetical LEC began, in Year 0, as a "pure" price cap carrier. Moreover, even if the FCC changes its existing price cap plan by eliminating the sharing options altogether, the adverse effects of cross subsidy from improper cost allocation will persist. This is because the telephone productivity factor will be deflated as described above. Ultimately, without reasonable cost allocations, interstate and intrastate telephone ratepayers will bear the burden of supporting those cross-subsidies.